No. 81-523

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

VS.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

APPELLANT'S REPLY BRIEF

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
JAMES P. KLEIER
One Market Plaza
Spear St. Tower,
34th Floor
San Francisco, CA 94105
Telephone: (415) 777-6000
Counsel for Appellant Container Corporation of America

Of Counsel
MORRISON & FOERSTER
One Market Plaza
Spear Street Tower
San Francisco, CA 94105

BOWNE OF SAN FRANCISCO, INC. • 180 NINTH ST. • S.F., CA 94103 • (415) 864-2300

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Parent and Non-100 Percent Owned Affiliates

A list of appellant's parent and non-100 percent owned affiliates is found in Appendix C to the Jurisdictional Statement at A-34, and there have been no changes to that list.

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APPELLANT'S REPLY BRIEF

INTRODUCTION

Appellant, Container Corporation of America (Container), will discuss arguments made by Appellee, Franchise Tax Board (FTB), and *amici* supporting the FTB in three areas: (i) the due process clause and the unitary concept; (ii) the due process clause and taxation of extraterritorial income; and (iii) the commerce clause and multiple taxation. Container believes no further argument is necessary regarding its position that worldwide unitary combination violates the commerce clause because it impairs the foreign policy of the United States. The FTB primarily asserts that the Court cannot prevent such interference unless Congress specifically forbids state action. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) and *Zschernig v. Miller*, 389 U.S. 429 (1968) are clear authority to the contrary.

I. THERE IS NO SUBSTANTIAL OPERATIONAL INTERDEPENDENCE BETWEEN CONTAINER AND ITS FOREIGN SUBSIDIARIES; CONSEQUENTLY, THE DUE PROCESS CLAUSE PROHIBITS THE TAXATION OF CONTAINER AND ITS FOREIGN SUBSIDIARIES AS A SINGLE UNITARY BUSINESS

A. The FTB and Its Amici Disregard the ASARCO and Woolworth Decisions

In its opening brief, Container demonstrated that there is no substantial operational interdependence between Container and its foreign subsidiaries. Container argued that under the most recent decisions of this Court, particularly *ASARCO Inc. v. Idaho State Tax Commission*, 50 U.S.L.W. 4962, 73 L. Ed. 2d 787 (1982), and *F.W. Woolworth Co. v. Taxation and Revenue Department*, 50 U.S.L.W. 4957, 73 L. Ed. 2d 819 (1982), the lack of any substantial operational interdependence prohibited California from taxing Container and its foreign subsidiaries as a single unitary business. Appellant's Br. at 40-49. The FTB and its *amici*, however, ignore the real meaning

of the *ASARCO* and *Woolworth* decisions, claiming that "these decisions are not directly applicable or controlling," Appellee's Br. at 62, and that the issues in those cases were "erroneously resolved." Multistate Tax Commission (MTC) Br. at 22, n.37.

Realizing that their position was untenable under *ASARCO* and *Woolworth*, the FTB and its *amici* chose to ignore the impact of those decisions, and conducted no comparison of the facts in those cases with the facts in the present case.[1] As set forth in Appellant's Brief on the Merits, when the proper factual comparison is made, it is clear that Container and its foreign subsidiaries operated as discreet businesses much like Woolworth and its foreign subsidiaries. Appellant's Br. 42-43. Thus, under *Woolworth* as well as *ASARCO*, Container and its foreign subsidiaries are not a single unitary business.[2]

ASARCO, *Woolworth*, *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980), and *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), all indicate that a state may justify taxing an enterprise as a unitary business only if there exist "factors of profitability" arising "from the operation of the business as a whole." *Woolworth*, 73 L. Ed. 2d 828, quoting *Mobil*, 445 U.S. at

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[1]While California and its *amici* hint that *ASARCO* and *Woolworth* have no relevance outside the area of apportionment of dividends, the Court has indicated that the opposite is true, remanding a case concerning the permissibility of unitary combination for consideration in light of *ASARCO* and *Woolworth*. *Russell Stover Candies, Inc. v. Department of Revenue, vacated and remanded*, 51 U.S.L.W. 3251 (U.S. Oct. 4, 1982) (No. 81-2080).

[2]The FTB ignores the impact of *ASARCO* and *Woolworth* not only in connection with the substantive issue of the definition of a unitary business under the due process clause, but also in its numerous unsupported statements regarding the manner in which this Court should review the decision of the court below. Appellee's Br. 2-5, 45-56. Those statements are unsupported by relevant authority and inconsistent with the obvious care and completeness with which this Court reviewed the records in *ASARCO* and *Woolworth*.

438. These factors of profitability, all of which must exist to a substantial extent, are "functional integration, centralization of management, and economies of scale." *Id.*

In Container's case, "there was little functional integration," as the Court in *Woolworth* defined this element. 73 L. Ed. 2d at 828. The subsidiaries located in each particular country operated as fully integrated, self-sustaining business operations, conducting every element of business operations themselves. Stip. ¶¶ 61, 111-113, 118, J.A. 30, 56-7, 59. In describing functional integration, the Court referred to *Exxon*, where there was a "highly integrated business" involving "a unitary stream of income of which the income derived from internal transfers of raw materials . . . is a part." *Woolworth*, 73 L. Ed. 2d at 828. Container and its foreign subsidiaries do not fit this description.[3]

There was no centralization of management or any other economy of scale. As in *Woolworth*, "each subsidiary operated as a distinct business enterprise at the level of full-time management." *Id.* at 829. The management of the foreign subsidiaries had complete authority and control over day-to-day business decisions. Stip. ¶¶ 127, 130, J.A. 65-66, 67-68. Such business decisions were not reviewed or subject to review by Container. Major policy matters, defined as consisting exclusively of capital appropriations, were also the responsibility of the foreign subsidiaries, but were generally subject to review by Container. Even in matters involving a major capital expenditure, the initiative rested with the foreign subsidiary, and local manage-

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[3]The FTB argues that no transfers of product occurred in either *Exxon or Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Appellee's Br. at 83-85. However, as noted in *ASARCO*, substantial transfers of product were essential to Exxon's business. 73 L. Ed. 2d at 803 n.24. Similarly, the central purchasing of inventory in *Butler Bros.* constitutes the transfer of product and provides the same functional integration and economies of scale as the transfers of raw materials in *Exxon*.

ment reserved the right to forego actual implementation of projects authorized by Container. All other policy matters were the complete responsibility of the foreign subsidiaries. Stip. ¶ 74, J.A. 39-40.

The FTB argues that Container's review and approval of capital appropriations resulted in centralization of management. Appellee's Br. at 23-24, 69-70. However, Container simply reviewed and generally approved such decisions made by the management of the foreign subsidiaries. Stip. ¶ 74, J.A. 39-40. This review and approval did no more than protect Container's interests as an investor in the subsidiaries. Thus, as in *Woolworth*, "[t]here were some managerial links," but these links do not rise to the level of management centralization or achievement of a significant economy of scale. "Except for the type of occasional oversight—with respect to capital structure, major debt and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of these . . . corporations." 73 L. Ed. 2d at 830-31.

B. The FTB and Its Amici Rely Entirely on the Sweeping California Definition of a Unitary Business, Refusing to Recognize the Definition Provided by the Court in Exxon, ASARCO and Woolworth Under the Due Process Clause

The FTB's argument regarding unity is based upon the sweeping premise that "taxpayers [are] operating a unitary business . . . . [i]f the in-state business is dependent upon or contributes to the out-of-state business in any material respect" and that "the due process requirements of unity should be no greater than California's contribution test." Appellee's Br. at 59, 60. The FTB makes no reference to the standards set forth in *ASARCO, Woolworth*, and *Exxon*, and ignores the fact that pursuant to the FTB's standard this Court would have reached a different conclusion with regard to some of the businesses in *ASARCO* and *Woolworth*. For example, in *ASARCO*

one of the subsidiaries, Southern Peru Copper Corp., sold about 35% of its output to ASARCO. 73 L. Ed. 2d at 798. Thus, under the FTB's standard, Southern Peru and ASARCO clearly "contributed" to, and perhaps were "dependent" upon the operations of one another.

Similarly, in *Woolworth*, the parent had common directors with some of the subsidiaries, reviewed all major financial decisions by the subsidiaries, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, and reinvested dividends in some of the subsidiaries. In addition, there was frequent "communication between the upper echelons of management of the parent and the subsidiaries." 73 L. Ed. 2d at 829, 830.[4] Despite any "contribution" which the parent may have made to the operations of the subsidiaries, the Court found that Woolworth was not engaged in a single unitary business with its foreign subsidiaries.

The constitutional deficiency of California's contribution test is aggravated by the FTB's continued reliance on its administrative presumption that companies engaged in the same line of business are conducting a single unitary business. Appellee's Br. at 82. The FTB ignores the fact that defining a unitary business in terms of a sweeping "contribution" test "would destroy the concept." *ASARCO*, 73 L. Ed. 2d at 801. Particularly when applied in combination with an administrative presumption such as California's, "this conception of the 'unitary business' limitation becomes no limitation at all," or is at best "arbitrary." *Id; see also* Appellant's Br. at 44-45. In short, the FTB, *sub rosa*, asks this Court to overrule its recent decisions in *ASARCO* and *Woolworth*.

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[4]The upper echelon of Container's management had significantly less contact with its subsidiaries. *Compare* Stip. ¶¶ 126-130, J.S. 65-68.

C. The Functional Integration Test of a Unitary Business Responds to the Reasons for the Resort to Apportionment; the Flow of Goods Element of that Test Provides a Badly Needed Objective Standard of Apportionment

In giving content to the "functional integration" requirement of a unitary business, the Court in *ASARCO, Woolworth,* and *Exxon* emphasized the substantial flow of raw materials, manufactured products, or inventoriable goods between subsidiaries or divisions of a manufacturing, producing or mercantile enterprise. This implementation of the functional integration test of a unitary business responds to the historical reasons for the development of apportionment. Apportionment was developed by the States because they found it difficult to localize, State by State, by cost accounting or any other method, the profits derived from businesses that manufacture or produce goods in one State and market them in others, or by mercantile businesses that buy goods in one State and sell them in others, and in other integrated industries. Consequently, the States found it necessary to resort to apportionment to divide the income of a unitary business.[5] However, where, as in this case, each of the companies essentially conducted all its basic operations—the production or purchase of raw materials, manufacturing and marketing—within a single country, the profit earned in each country can be determined by looking solely to the operations in that country, without taking into account the operations conducted in other countries. Indeed, to attribute income by the apportionment method in such cases tends to produce the type of misattribution and distortion of income that the facts of the instant case disclose.

In addition to being basic to the underlying reason for formulary apportionment, the substantial flow of goods

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[5] *See* Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," 21 National Tax Journal 487 (1968).

requirement[6] has the further advantage of introducing an objective factor into an otherwise largely subjective determination as to whether the business is unitary. Adopting such an objective standard would reduce the number of cases in which it is necessary to refer to factors such as centralized management and services, which are often not operational in character, but directed to protection of the parent's interest as a shareholder.

D. Not Only Does the FTB Build its Case on an Erroneous Legal Standard, But Also its Argument is Based in Substantial Part on Suppositions and Distortions, Not on Facts of Record

Having ignored the proper test enunciated in *ASARCO* and *Woolworth*, the FTB proceeds to apply its unique view of the facts to its erroneous legal standard. The heart of its factual argument is a forty-six page review of sixteen items which the FTB contends demonstrate Container's "contribution" to its foreign subsidiaries. Appellee's Br. 5-36, 68-83. Some of the items do not show any contribution by Container at all.[7] The others either show only that Container took precautions to protect its interest as an investor,[8] or that Container took no significant role

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[6]A flow of goods or products needs to be substantial to make the business unitary, but that is not an issue in the instant case. Here there is no need to determine what constitutes a substantial flow of goods or products since by any standard the flow of goods and products between Container and its subsidiaries was so inconsequential as not to be substantial. Appellant's Br. at 4.

[7]*E.g.*, Item 2 refers to procedures Container established for the subsidiaries to use in transmitting financial reports from their own complete accounting records to Container. Item 5 shows that Container and the subsidiaries used different law firms and that Container's general counsel spent part of his time handling Container's (not the subsidiaries') international legal affairs. Appellee's Br. at 69, 71.

[8]*E.g.*, Item 1 refers to procedures in acquiring or forming new subsidiaries. Item 4 refers to auditing by an accounting firm. Item 5 discusses loans by Container to the subsidiaries. Item 15 mentions the review by Container's management of capital appropriations. Appellee's Br. at 69, 71, 77.

in the operations of the subsidiaries (these are discussed hereinafter). Moreover, in order to make these items seem important the FTB has overstated or misstated the facts in a number of instances.[9]

A typical example of overstatement is found in Item 12 of the FTB's list, at page 75 of its brief, where it attempts to demonstrate that "the paperboard/packaging function was integrated under CCA's control." In support of this contention the FTB states that Container contracted to "and did, provide all technical, management and other assistance needed by the subsidiaries to function in that business." Appellee's Br. at 75. This statement is contradicted by the Stipulation. The FTB's effort to support its position by reference to the contracts to provide technical services (*i.e.*, Technical Service Agreements) ignores this

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[9]There are two particularly offensive misstatements. First, on page 69 of its brief the FTB sets out what purports to be a quotation from paragraph 28 of the Stipulation of Facts as support for its contention that "site selection and expansion of markets was [sic] centrally controlled." What the FTB has set forth as a quotation, however, appears nowhere in the record, but is instead a description which has been created by the FTB and represented to this Court to be part of the Stipulation of Facts. Moreover, the actual language of paragraph 28 of the Stipulation of Facts, J.A. 16-17, shows that there is no mention of any review or control over site selection, nor does the paragraph refer to a direct market expansion by an existing subsidiary. Instead, the paragraph explains the procedures followed in acquiring or forming new subsidiaries and expanding markets by that means.

Similarly cavalier treatment of the record is found elsewhere. Thus, on page 70 of its brief the FTB contends that Container centralized and integrated financial planning for its foreign subsidiaries, and quotes the Stipulation as stating, "The budgets were submitted to CCA . . . . These were usually reviewed by CCA in connection with its annual meeting." Convenient use of ellipsis aids the FTB here, since the omitted language states that the budgets were submitted to CCA "for information *but not specific approval.*" Stip. ¶ 134, J.A. 70 (emphasis added). Elsewhere paragraph 134 states that, "During these years there was little profit planning," and that the subsidiaries' directors had final approval of capital projects and substantial control over borrowing funds. *Id.*

stipulated evidence.[10] Very little in the way of technical assistance was provided pursuant to the Technical Service Agreements, even though those agreements were worded very broadly. Furthermore, such agreements were not entered into with the important Colombian and Venezuelan subsidiaries. Stip ¶ 146, J.A. 76.[11]

The FTB makes an additional overstatement by its repeated references to Container's "concession" that the fair

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[10]Container offered little material assistance in developing techniques for processing raw material and for adapting machinery to different grades of paperboard. Stip. ¶¶ 76, 84, 85, 146, J.A. 41, 44-5, 45-6, 75-6. Similarly, Container had little or no role in the production of paperboard-based packaging by its subsidiaries, since the functional and graphic designs of the packages which Container manufactured were generally ill-suited to the products and markets served by the foreign subsidiaries. Stip. ¶¶ 56, 57, 66-70, 73, J.A. 27-8, 34-7, 39.

Furthermore, the provision of technical services by ASARCO to its subsidiaries appears to have been far more significant. Exploration services were provided on a centralized basis. ASARCO Joint Appendix at 90. In addition, ASARCO's central research department made its findings available to all of the subsidiaries. *Id.*

[11]Similarly overstated are the FTB assertions that "CCA provided a centralized source of key personnel" and that "centralized personnel training at CCA was provided." Appellee's Br. at 73. *Compare*, Stip. ¶ 119, J.A. 60-1 (limited number of former Container employees employed by foreign subsidiaries); Stip. ¶ 123, J.A. 64 (difficulty of adjusting to foreign countries); Stip. ¶ 132, J.A. 69 (no U.S. training program for foreign subsidiaries).

There are other examples of overstatements. Item 10 (Appellee's Br. at 74) alleges that key subsidiary employees "in substance" remained employees of Container. In fact, this was done as a service to a few employees; at *their* request Container paid them in dollars due to special circumstances. Container was reimbursed by the subsidiaries for both the payroll costs and Container's accounting costs. Stip. ¶ 125, J.A. 65. There is no evidence Container controlled these employees. Container's efforts to accommodate these employees is comparable to Woolworth's action in keeping some employees of the Spanish and Mexican subsidiaries in the parent's pension plan. *Woolworth* Joint Appendix, pp. 50-51. In fact, Woolworth itself made contributions to the plan on behalf of these employees. *Id.*

market value of some of the services it provided to subsidiaries could not be determined. *See, e.g.,* Appellee's Br. at 81-82. However, the Stipulation makes clear that in those instances charges were made by apportioning "the overhead of the relevant staff department".[12] Stip. ¶ 144, J.A. 74-75. Furthermore, the FTB has stipulated that all reasonable charges for services and other items which should have been made were in fact made. The parties stipulated that the figures in Exhibits A and B to the Stipulation, including the net incomes of Container and the subsidiaries "are accurate." Stip. ¶ 21, J.A. 11. For the net income figures to be "accurate" they must obviously take into account all adjustments which would be appropriate

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[12]The FTB's claim that in some instances reasonable charges were not made by Container to the subsidiaries is unimpressive. See Appellee's Br. 32, *et seq.* Reference is made to the fact that Container charged inadequate interest on certain loans to foreign subsidiaries. The effect of such "loans" is thus similar to Woolworth's policy of reinvesting dividends in its German subsidiary. 73 L. Ed. 2d at 829 n.14; Woolworth Joint Appendix at 31, 51. As to the remainder of the claimed undercharges, it is questionable whether Container should have made any charges at all, or, if they should have been made, whether the revised charges would have made any significant difference in determining the net income of Container or the subsidiaries. It is stipulated that "no adjustments to income or deductions pursuant to Internal Revenue Code Section 482 were proposed by the Internal Revenue Service" for the years in issue. Stip. ¶ 151, J.A. 78-79. Furthermore, one of the claimed undercharges is incorrect; the Colombian subsidiary repaid the advances made by Container and the Colombian government to the joint venture discussed at Stip. ¶ 158, J.A. 81-82. In addition, even if a reasonable charge had not been made in certain instances, this would not indicate, as the FTB contends, that a single unitary business existed under the standards enunciated by this Court. Rather, such a fact would indicate that the IRS and/or the FTB might have grounds for adjusting the income of Container and the foreign subsidiaries in accordance with normal separate accounting, arm's-length principles, pursuant to Section 482 of the Internal Revenue Code and Section 24725 of the California Rev. & Tax. Code. *See* Hellerstein and Hellerstein, *State and Local Taxation*, 501-02 (4th ed. 1978).

under the separate accounting, arm's-length method. It is far too late in the day for the FTB to challenge the stipulated figures.

While in this case, as in *ASARCO* and *Woolworth*, there are undoubtedly some ways in which a parent contributed to its foreign subsidiaries, the FTB's list of alleged contributions is not an accurate representation of any such contributions, and, even if it were, it does not demonstrate any substantial operational interdependence. A review by this Court of the Stipulation and the other evidence of record contained in the Joint Appendix will demonstrate that "*no* phase of any subsidiary's business was integrated with the parent's," 73 L. Ed. 2d at 828, so that the FTB may not tax Container and its foreign subsidiaries as a single unitary business.

II. CALIFORNIA'S APPORTIONMENT VIOLATES THE DUE PROCESS CLAUSE BECAUSE IT TAXES INCOME EARNED IN FOREIGN COUNTRIES AND NOT IN CALIFORNIA

Container's opening brief demonstrated that world-wide unitary combination frequently (including in this case) misapportions income to the United States members of a unitary group, resulting in extra-territorial taxation in violation of the due process clause. In an effort to confuse this issue, the FTB and its *amici* have disputed Container's analysis, notwithstanding that it is based upon stipulated figures. Before answering the arguments of the FTB and its *amici*, certain undisputed facts should be reviewed.

1. For the years in dispute, the FTB determined an additional franchise tax liability for Container by adding approximately $41 million of foreign subsidiary income to the apportionable tax base. J.A. Ex. 7. The FTB used the book income of the subsidiaries (taken from the federal income tax Forms 2952) in computing this sum. Stip. ¶ 21, J.A. 11-12.

2. Formulary apportionment determines the income of each member of the group by multiplying the apportionable base by the factors attributable to each member of the group. The effect of formulary apportionment in this

case is to apportion about half the income of the most profitable subsidiaries in Colombia and Venezuela away from those subsidiaries to Container, principally, and to a lesser extent to certain European subsidiaries. Stip. re Testimony, Sched. VI, J.A. 109-113; Appellant's Br. 17.

3. The foreign subsidiaries filed income tax returns in the countries in which they were located on a separate accounting basis and paid substantial taxes to those countries. Stip. ¶¶ 140, 159, J.A. 72, 83-4.

4. The net incomes of Container and the subsidiaries on a separate accounting basis are set out in the record and stipulated by the parties to be accurate. Stip. ¶ 21, J.A. 11-12.

As a first attack upon Container's due process argument, the FTB argues that separate accounting can never be used to impeach formulary apportionment, citing, *inter alia, Exxon Corp. v. Wisconsin Department of Revenue,* 447 U.S. 207 (1980), and *Butler Bros. v. McColgan,* 315 U.S. 501 (1942). However, this Court has endorsed use of separate accounting analyses to impeach formulary apportionment in *Norfolk & Western Railway Co. v. Missouri State Tax Commission,* 390 U.S. 317 (1968), and *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123 (1931). *See Moorman Manufacturing Co. v. Bair,* 437 U.S. 267, 272 (1978); *see also Exxon,* 447 U.S. at 233. Of course, the Court has held that in order to invalidate a formula the taxpayer must do more than simply present its own separate accounting analysis; the taxpayer must also introduce evidence explaining why the formula is inadequate and produces an unfair result. The taxpayers introduced such evidence in the *Hans Rees'* and *Norfolk* cases and Container has done so here.[13]

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[13] In its opening brief, Container argued that under these circumstances, at a minimum, the burden of proof shifts to the state, as the Court held in *Norfolk.* Appellant's Br. at 20. The FTB has offered no response to this argument—nor did the FTB offer any evidence at trial to meet its burden.

Container has explained the inadequacy of the formula by showing that the subsidiaries operated under political and economic conditions quite different from those in the United States, particularly in regard to the subsidiaries in Colombia and Venezuela; that the cost of labor is significantly less in those countries than in the United States; that those subsidiaries are much more profitable than Container, and that their factors, particularly payroll and sales, realize a considerably greater return than do those of Container. Appellant's Br. 11-21. The FTB has not denied these basic facts. Nor has the FTB disputed that U.S. businesses use a higher "hurdle rate" in making investments in foreign countries and that this greater rate of return is generally achieved. Thus, Container's explanation for the unfairness resulting from combined apportionment on a unitary basis remains unchallenged.[14]

The FTB next argues that even if separate accounting may be used to impeach the formula, the separate accounting figures in the record are not accurate. Appellee's Br. at 96-8. As stated above, however, the parties have stipulated to the accuracy of the figures in Exhibits A and B and in making this stipulation the FTB was well aware of the charges made by Container for whatever services it provided the subsidiaries. The parties are bound by those figures.

The FTB next attempts to justify the taxation of income earned outside California on the ground that the extraterritorial income apportioned to California is not substantial in amount and that formulary apportionment need only achieve a "rough approximation" in apportioning

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[14]It must also be kept in mind that Container's use of the separate accounting method was not solely a matter of internal convenience, as in *Exxon* and *Butler Bros.* A separate accounting computation was required of Container by the Internal Revenue Code, and of the subsidiaries by the tax laws of the countries in which the subsidiaries operated. *See* Stip. ¶¶ 140, 151, J.A. 72, 78; Appellant's Br. 25 n. 11.

income to the State. *E.g.*, Appellee's Br. at 98. However, under the FTB's method, about half of the income of the most profitable subsidiaries (Colombia, Venezuela and Holland) would be apportioned away from those subsidiaries and, principally, to Container. In fact nearly 30 percent of all the income of the foreign subsidiaries is apportioned to Container. Appellant's Br. at 17. This hardly amounts to "rough approximation."[15] The FTB has not attempted to defend this bald reallocation of income earned outside California. Under these circumstances *Hans Rees'* and *Norfolk* require a holding that the FTB's method of apportionment violates due process.

There is a further consideration in regard to the "rough approximation" rule. The Court's statement that apportionment is satisfactory if it roughly approximates income earned in the State has been applied mainly in the context

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[15]The FTB complains that the computation on page 16 of Appellant's brief is not based on "tax" figures, and the MTC appears to make a similar complaint in regard to the chart on page 17 of Appellant's Brief. (Appellee's Br. 36; MTC Br. 18-19) Container used the net income and apportionment figures appearing in the record and which were stipulated to be accurate. J.A. Exhibits 1-6; Stip. ¶ 21, J.A. 11. These figures are taken from the books of the subsidiaries and Container. The tax figures for Container are set forth at J.A. 7. Container used book figures because the FTB used the book figures of the subsidiaries in computing Container's worldwide income. Stip. ¶ 21, J.A. 11. Because, as the record shows, taxable net income may vary somewhat from book net income (Stip. ¶ 161, J.A. 85), Container maintains that a valid comparison can only be made by using Container's income derived from its books and the book income of the subsidiaries. However, if Container's taxable net income is used, the results do not vary greatly. It is still clear that the formula method reapportions almost half of the income of the Colombian, Venezuelan and Dutch subsidiaries away from those countries and principally to Container. *See* Appendix A.

of interstate commerce. Here we are concerned with *foreign* commerce, where, as the Court said in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 455-6, "true apportionment does not exist and cannot be policed by this Court at all." Thus, the efforts by the states to tax income earned outside their borders should be guarded against more vigorously in connection with foreign commerce than interstate commerce.

The FTB next argues that even if the facts show different rates of return for the factors as between Container and its foreign subsidiaries, this does not impeach formulary apportionment. The FTB attacks Container's statement that formulary apportionment is based upon the premise that a dollar of payroll or property expended or used in one state and a dollar of sales realized in one state typically produce roughly the same amount of income as a dollar so spent or sales realized in another state. Appellee's Br. at 99-100. The premise, however, is confirmed by the leading commentators on state and local taxation.[16] Furthermore, a moment's reflection will show that the premise must be correct. After all, the three-factor formula cannot validly operate over a substantial period of time if the return on payroll, property or sales in one geograph-

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[16] Hellerstein & Hellerstein, *supra* note 12, at 539 states:

> The underlying premise of formulary apportionment under the Massachusetts three-factor formula is that (using UDITPA as illustrative), by and large, every dollar of wages or property spent in one taxing jurisdiction, along with receipts from sales in the area, will produce the same amount of profit in all taxing jurisdictions. Wide disparities in unit labor or unit property costs between taxing jurisdictions tend to attribute to the high wage-property cost jurisdictions, such as the United States, income which is attributable to other jurisdictions. . . .

ical area will be much less or much greater than in another geographical area.[17]

The FTB cites an article which argues that a return on investment analysis may be inappropriate for evaluating the performance of the management of foreign subsidiaries. Appellee's Br. at 103-07. To the extent that commentary has any relevance here, the record in this case is to the contrary. Professor McDonald testified that he reviewed the return on investment analysis in Schedule VI to the Stipulation re Testimony (J.A. 109-13), and that the method used is appropriate and "the generally accepted way of calculating return on investment." J.A. 177.

The FTB also argues that while the three factors of property, payroll and sales are interdependent, Container is attacking the payroll factor independently of the others. Appellee's Br. at 102-03. The FTB cites *Norfolk and Western Railway Co. v. North Carolina*, 297 U.S. 682 (1936), for the proposition that a taxpayer cannot demonstrate the invalidity of a formula by attacking only one element of the formula. The short answer to the FTB's argument is that Container has not limited its attack to the payroll factor; all of Container's computations showing distortion take into account all three factors. Thus, *Norfolk and Western* is not applicable.

Finally, contrary to the FTB's assertion, all of the data pertaining to Container involve the years in suit except for the unit cost comparison, which involves the year 1974. Container's assistant controller testified, however,

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[17] *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952), cited by the FTB (Appellee's Br. 100), does not militate against the premise. There, a corporation operating within the United States incurred greater costs in California as a result of the introduction of a new product. In the present case the distortion occurs not as a result of such short-term differences but because of substantial economic differences between the United States and the countries in which the subsidiaries operate, especially in regard to payroll costs and rates of profitability.

that in his opinion the comparison for the year 1974 would be substantially the same, or even more favorable to Container, if the comparison could have been made for the years in suit. Stip. re Testimony, J.A. 115. Furthermore, the other figures presented by Container are all specifically for the years in suit, or closely related to those years, except where a comparison with more recent figures is deliberately made.

III. CALIFORNIA'S APPORTIONMENT VIOLATES THE COMMERCE CLAUSE BECAUSE IT RESULTS IN MULTIPLE TAXATION OF FOREIGN SOURCE INCOME

The FTB does not seriously dispute that, in the present case, multiple taxation of the same income occurs by California and the countries where the most profitable subsidiaries are located (Colombia, Venezuela, Holland and Mexico). The facts are as follows:

1. Each subsidiary filed income tax returns on a separate accounting basis with the country wherein the subsidiary operated. Stip. ¶ 140, J.A. 72.

2. The actual amounts of income taxes paid by the subsidiaries in Colombia, Venezuela, Holland and Mexico are set out in a table in the record. Stip. ¶ 159, J.A. 83-84. In only minor instances in Venezuela, and one instance in Mexico, does the table show a provision for taxes stated on Form 2952, rather than the actual taxes paid by the subsidiaries. The record states, however, that the provision for taxes is very close to the actual taxes paid. Stip. ¶ 160, J.A. 85.

3. The record contains the net income of the subsidiaries computed in accordance with generally accepted accounting principles. Stip. ¶ 160, J.A. 85. This net income was included in the Forms 2952 filed by Container with its federal income tax returns, and it is the net income which the FTB auditor used in combining the income of the subsidiaries with that of Container. Stip. ¶ 21, J.A. 11. As a

consequence, the record contains the book net income of the subsidiaries which was used to compute the California tax, the California franchise tax paid on that income and, with minor exceptions, the actual net income taxes paid by the Colombian, Venezuelan, Dutch and Mexican subsidiaries to their governments.[18] There can be no question, therefore, that the net income of the subsidiaries was taxed once by the foreign countries involved and again by California. The FTB does not rebut the above,[19] but simply reiterates that California is only taxing Container and not the foreign subsidiaries, conveniently ignoring the undisputed evidence of multiple taxation.

The FTB's efforts to limit the Court's decision in *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), to property taxes on containers is unavailing. *Japan Line's* holding that state taxation in the area of foreign commerce raises the additional issues of multiple taxation as between the state and foreign governments and of impairment by the state of federal policy is certainly not limited to property taxes. In this regard see the *amicus* memorandum filed for the United States in *Chicago Bridge and Iron Company v. Caterpillar Tractor Co.*, No. 81-349, set forth in pertinent part in Appendix F to Appellant's Brief on the Merits.

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[18] A simple comparison of taxes paid by the subsidiaries to their book net income demonstrates that substantial taxes were paid on that income for the years in question. Compare Stip. ¶ 159, J.A. 84 with Exhibits A-1 to A-6, J.A. Exhib. 1-6.

[19] Because the record in the main shows actual taxes paid, rather than a provision for taxes, the unfounded attack by the MTC and other *amici* supporting the FTB on the provision for taxes of the Italian subsidiaries is unimportant. (MTC Br. 7, 21 n. 35.) In any event, the MTC erroneously offsets the losses of some subsidiaries against the profits of others, thereby showing that the Italian subsidiaries *as a group* had an average net income of only $34,000 for the years, whereas the average tax provision was over $121,000. The MTC overlooks the fact, *inter alia*, that under the Italian net income tax law the losses of one corporation cannot be offset against the profits of another. *See* Harvard University, *World Tax Series—Taxation in Italy* 335, 423-24 (1964).

The Court's decision in *Mobil Oil Corp. v. Commissioner of Taxes*, 455 U.S. 425 (1980), does not bar the application of *Japan Line* to this case. *Mobil* did not involve worldwide unitary combination where a conflict between taxation of income by a state and foreign governments is a major issue. *Mobil* involved a conflict in taxation of dividends as between the states; a conflict between the State of Vermont and foreign governments was not involved.

In a confusing argument the FTB appears to concede that some of the same income is being taxed twice, once when apportioned to California as income of Container and once by the foreign countries which tax the subsidiaries on a separate accounting basis. Appellee's Br. at 116-18. However, the FTB equates taxation by the federal government and the states of the same income of a United States corporation with the taxation by California and foreign countries of the same income of foreign subsidiaries of a United States parent. Those foreign countries are not members of a federal system with California wherein both governments are supplying governmental services to a taxpayer. Moreover, while the same dollar of income could be "earned" in both California and the United States, thereby justifying taxation by both jurisdictions, the same dollar of income cannot have been earned in both California and Colombia. Thus, California is not entitled to tax subsidiary income which is earned in a foreign country and taxed by the foreign government.[20]

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[20]The FTB's reliance upon the foreign tax credit against Container's federal income tax is misplaced. I.R.C. § 901. The foreign tax credit only helps to prevent multiple taxation where the federal government is taxing income also subject to tax by a foreign government. Since the federal government does not tax the undistributed income of foreign subsidiaries of U.S. parents (except for Subpart F, Sections 951-964, I.R.C., which does not apply to Container's operating subsidiaries), no foreign tax credit would be available for the type of multiple taxation being imposed in this case. Furthermore, the foreign tax credit applies only to the federal income tax. California does not provide such a credit.

CONCLUSION

Container submits that the issues in this case are clearly resolved by application of leading decisions of this Court. *ASARCO* and *Woolworth* require a holding that Container and its foreign subsidiaries are not unitary because of the lack of substantial operational interdependence. *Hans Rees'* and *Norfolk & Western Railway v. Missouri* compel a decision that worldwide unitary combination violates the due process clause because of the resulting state taxation of extraterritorial income, and *Japan Line* similarly requires a holding that such combination violates the commerce clause because of the resulting double taxation and impairment of the ability of the federal government to speak with one voice in regard to foreign policy.

For the foregoing reasons, Container submits that the decision of the California Court of Appeal should be reversed.

Dated: December 23, 1982.

Respectfully submitted,

FRANKLIN C. LATCHAM
COUNSEL OF RECORD
PRENTISS WILLSON, JR.
JAMES P. KLEIER
Counsel for Appellant Container Corporation of America

Of Counsel
Morrison & Foerster

APPENDIX A

Restatement of Chart, Appellant's Brief on the Merits page 17, based on taxable separate accounting income for Container and book separate accounting income for the subsidiaries.

1963 - 1965
(000's omitted)

		Average Pre-Tax Income Per Arm's Length in Different Countries	Average Pre-Tax Income per Worldwide Apportionment
1.	Container (United States)	$31,549	$34,704
2.	Colombia	4,253	2,383
3.	Mexico	1,605	1,547
4.	Venezuela	4,246	2,064
5.	Panama	1,286	0
6.	Austria	(13)	12
7.	Germany	1,793	3,145
8.	Holland	384	214
9.	Italy	34	1,069
10.	Total Foreign	13,588	10,433*
11.	Total Combined	45,137	45,137

* Rounding-off of numbers in multiplication causes slight discrepancy from addition of the column.